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IN THE

Supreme Court of the United States

OCTOBER TERM, 1969.

No. 528

UNITED STATES OF AMERICA,
Petitioner,

vs.

HILTON HOTELS CORPORATION,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR HILTON HOTELS CORPORATION.

ARGUMENT.

INTRODUCTION AND SUMMARY.

Hilton Hotels Corporation ("Hilton") and the Hotel Waldorf-Astoria Corporation ("Waldorf") entered into a merger agreement. Under the New York law governing the merger, stockholders of Waldorf voting against the merger could demand payment for their Waldorf stock. Certain dissenting Waldorf stockholders demanded payment and by so doing under the terms of New York law they lost their status and rights as stockholders of Wal-

dorf, and they became creditors of Waldorf for the fair value of their stock. As a result of the merger Hilton assumed Waldorf's debts. Hilton and the dissenters could not agree on the amount of the debt to the dissenters. An appraiser was appointed by a court to determine the fair value of the stock, and thus determine the amount of the debt.

The problem presented to the Court in this case is whether the expenses by Hilton in the New York appraisal proceeding are to be classified as ordinary and necessary business expenses deductible under § 162[1] or as non-deductible capital expenditures described in § 263. As the Government states (U. S. Br. p. 11) there is no dispute between the parties as to the basic rules of Federal taxation, but the dispute centers around the application of these rules.

It is the taxpayer's position that its expenses in the appraisal proceeding are ordinary and necessary expenses deductible under § 162 because such expenses were not incurred to acquire a capital asset, but rather were incurred solely to determine the amount of the debt of Hilton to the dissenting shareholders, which debt was created when the dissenters filed their objection to the merger and demand for payment of the value of their stock with Waldorf. The previously accomplished acquisition of the dissenters' shares was not involved in the appraisal proceeding, said shares having been acquired when the debtor-creditor relationship was established, with all of the terms of such acquisition having been determined, including the purchase price, which was to be the fair value of the dissenters' shares. All of the attributes of stock ownership were lost to the dissenters prior to the appraisal and no unilateral act by them could restore title to the stock to them, nor change the terms of the acquisition.

Since the origin of the appraisal proceeding was in the

1. All references to section numbers, unless otherwise indicated, are to the Internal Revenue Code of 1954.

election of the dissenters to receive the fair value of their shares, and not in the merger, and since the character of that proceeding was only to determine such fair value, the appraisal proceeding was not functionally related to the merger, so as to have the rules relating to capitalization of merger expenses apply to the appraisal proceeding expenses. Rather, the established Federal income tax rules relating to the deductibility of expenses in determining the amount owed by one party to another are applicable to the instant case.

Many cases hold that where title is not in question but where merely the agreed amount of the acquisition price is in question, expenses incurred in determining that amount are deductible. The expenses are solely for the resolution of a dispute regarding the amount of a debt. Such a resolution gives the corporation no permanent benefit as does a merger or stock acquisition. The expenses are not capital expenses but rather are properly deductible.

I.

The Appraisal Proceeding Did Not Involve the Acquisition of Stock Nor Was It Functionally Related to the Merger.

The Government concedes (U. S. Br. p. 10) that the expenditures by Hilton in the appraisal proceedings having been made in a business context, are deductible unless they fall within the ambit of capital expenditures which are defined as "any amount paid . . . to increase the value of any property or estate." (§ 263). In this case, the touchstone in determining whether the expenditure increases the value of any property or estate is whether the expenditure is for "defending or perfecting title to property." (Treasury Regs. § 1.263 (a)-2(c)).

The Government also concedes (U. S. Br. p. 19) that this touchstone to the applicability of § 263 is absent in this

case by its admission that it agrees "with Hilton . . . in terms of the timing of title passage . . . [under] New York law." However, a further analysis of the origin and character of the New York appraisal proceeding is necessary to aid in evaluating the Government's arguments (1) that the origin and character of the New York appraisal proceedings are such as to bring Hilton's expenditures in the appraisal proceeding within the tax rules applicable to mergers under the rationale of the *Gilmore* case[2] and (2) that the expenses of the appraisal proceeding are a part of the acquisition cost of stock under the rationale of the *Winmill* case.[3]

Prior to the meeting of the shareholders of Waldorf to consider the merger of Waldorf into Hilton, certain shareholders of Waldorf filed *with Waldorf* their written objection to the merger (called a consolidation under New York law) and demanded payment for their stock. (R. 7, par. 18). The filing of the written objection to the merger and the demand for payment, had the following results under New York law as of the date of the vote by Waldorf shareholders approving the merger (December 28, 1953)[4]:

1. The dissenting shareholders lost their status and all of their rights as shareholders of Waldorf.[5]

2. The dissenting shareholders had the right only

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2. *United States* v. *Gilmore*, 372 U. S. 39 (1962).

3. *Helvering* v. *Winmill*, 305 U. S. 79 (1938).

4. N. Y. Stock Corp. Law § 21(1): "In the event that the stockholders of a corporation have taken action pursuant to section . . . ninety-one" (approved the merger) the New York statutory provisions for determination of the value of the stock of dissenting shareholders become effective. R. 7, par. 19.

5. N. Y. Stock Corp. Law § 21(6). Their status as shareholders could not be restored by withdrawing their demand for payment.

to receive the fair value of the Waldorf stock and thereby became creditors of Waldorf.[6]

The filing of the Certificate of Consolidation with the Secretary of State of New York on December 31, 1953[7] had the following results under New York law as of said date:

1. Hilton acquired all of the properties of Waldorf, subject to its liabilities, including Waldorf's liability to pay the dissenting shareholders the fair value of their stock.[8]

2. The approving Waldorf shareholders became shareholders of Hilton.[9]

3. Hilton retained the Hilton stock otherwise issuable to the dissenting shareholders.[10]

In summary, upon the approval of the merger by the Waldorf shareholders, the relationship between the dissenting shareholders and Waldorf became a debtor-creditor relationship, with Waldorf owing the dissenting share-

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6. N. Y. Stock Corp. Law § 21(6). Dissenting shareholders were required to submit their Waldorf stock certificates for the placing of a notation thereon of the fact of their demand for payment. No transferee of the notated certificate had any right under the certificate other than the right of the transferor for payment for his shares. N. Y. Stock Corp. Law § 21(8). However, if the merger had not been consummated, the dissenters' status as creditors would have terminated. N. Y. Stock Corp. Law § 21(6).

7. R. 7, par. 20.

8. N. Y. Stock Corp. Law § 85(1), § 91(6).

9. R. 23.

10. Such stock being "deemed to have been duly issued in accordance with the terms of such certificate [of consolidation] and reacquired by the . . . surviving corporation" to "be held or disposed of by it free of any preemptive rights of stockholders." N. Y. Stock Corp. Law § 21(7).

holders the value of their Waldorf stock.[11] Upon the consummation of the merger, Hilton assumed this liability of Waldorf, together with Waldorf's other liabilities. Hilton neither purchased or acquired the Waldorf stock owned by the dissenting shareholders. Thus, the acquisition, defense or perfection of title to the dissenters' shares by Hilton was not involved in the merger.

The statutory scheme in New York required Hilton and its new creditors to determine by agreement the amount of the debt owed to the dissenters[12] and pursuant thereto Hilton made a cash offer to the dissenting shareholders.[13] Had the dissenting shareholders accepted the offer, no appraisal proceeding would have been necessary, and Hilton's debt would have been liquidated by the payment of its offer.[14] However, the Hilton offer having been rejected, the dissenting shareholders began an appraisal proceeding under New York law to have the value of their stock determined.[15] The appraisal proceeding thus related functionally *only* to the determination of the amount owed by Hilton to the dissenting shareholders, and would not have been necessary had the parties agreed on the value of the stock. The dissenting shareholders initiated the appraisal proceedings[16] independently of the fact of the completion of the merger, and *solely* to obtain a judicial resolution of

11. *Beloff* v. *Consolidated Edison Company*, 300 N. Y. 11, 87 N. E. 2d 561 (1949); *Pikor* v. *Cinerama Products Corporation*, 25 F. R. D. 92 (E. D. N. Y. 1960); *Voege* v. *Sumatra Tobacco Corporation*, 241 F. Supp. 369 (1965); *Brasch* v. *Goldschmidt*, 199 A. 2d 760 (Del.) (1964); *Southern Production Co., Inc.* v. *Sobath*, 87 A. 2d 128 (Del.) (1952).

12. N. Y. Stock Corp. Law § 21(1).

13. R. 7, par. 21.

14. N. Y. Stock Corp. Law § 21(2), § 21(3).

15. R. 7, 8, par. 21. N. Y. Stock Corp. Law § 21(3).

16. Hilton also had the right to initiate the proceedings. N. Y. Stock Corp. Law § 21(3).

the amount of the debt from Hilton to them. Nothing in the appraisal proceedings, or the fruitless offer by Hilton leading up to them, was intended or could in any way affect the merger or title to the stock of the dissenting shareholders, and there was no functional relationship between the appraisal proceeding and the merger.

II.

The Rules Relating to Mergers Are Not Applicable to the Appraisal Proceeding as the Merger and the Appraisal Were Not Functionally Related.

Faced with the problem that § 263 cannot be applied to the appraisal proceeding when viewed alone, because the acquisition, defense or perfection of title was not involved in the appraisal proceeding, the Government argues (U. S. Br. pp. 14, 15) that the rules applicable to merger costs should be applied to Hilton's expenses in the appraisal proceeding. In support of its argument the Government cites the *Gilmore* case, and urges its application to the instant case, stating that the "origin" of the appraisal proceeding was in the merger (through the dissenters losing their rights as shareholders) and the "character" of the proceeding was the amount to be paid for a capital asset. In other words, since there would have been no appraisal proceeding if there had been no merger, the expenses of the appraisal proceeding are merger expenses.[17] The Government's argument is erroneous for two reasons: (1) It has misinterpreted the *Gilmore* case, and (2) it has not correctly characterized the functional relationship of the appraisal proceeding and the merger.

Mr. Gilmore was unable to deduct a portion of his litiga-

17. See *The Vermont Bank and Trust Company* v. *U. S.*, 296 F. Supp. 682, at 684-685 (D. C. Vt. 1969), which discusses this argument.

tion expenses in the California divorce proceeding because ***both*** the origin of the proceeding and the character of his wife's claim were personal. The origin of divorce litigation was in the personal marital relationship of the parties. The character of Mrs. Gilmore's claim was two-fold: (1) that she be granted a divorce and (2) that she be granted title to a greater portion of the community property than she would have otherwise been granted, based in both cases upon Mr. Gilmore's alleged infidelity. Both the divorce issue and the title issue were determined by the California court on the basis of the infidelity of Mrs. Gilmore during the marriage. Neither the origin or the character of the claim in the *Gilmore* case was in a business context relating to profit making activities, and other than the marital relationship of the parties, title to property was the issue in the litigation.

In contrast to the *Gilmore* case, the origin of the New York appraisal proceeding was clearly in a business context resulting from the failure of Hilton and the dissenting shareholders to agree on the amount owed to the dissenting shareholders.[18] The debtor-creditor relationship established first between Waldorf and the dissenting shareholders, and later assumed by Hilton, was the origin of the appraisal proceeding. This debtor-creditor relationship was created by the dissenting shareholders, and Hilton did not participate in the creation of the relationship nor acquire anything as a result of the creation of the relationship. Had the merger not been proposed, the debtor-creditor relationship could not have been established. However, the causal relationship between the merger and the appraisal proceeding is broken because the appraisal proceeding was a creature not of the merger, which in itself would not have caused the appraisal proceeding, but rather the objection and demand for payment of the dissenting

18. *Beerman* v. *United States*, 390 F. 2d 638 (C. A. 6, 1968).

shareholders, and the failure to agree on value, caused the appraisal proceeding. [19]

To characterize the appraisal proceeding initiated by the dissenting shareholders as originating in the merger is an extension of the holding of the *Gilmore* case beyond its intendment, which would cause many expenditures which may have been incurred by Hilton relating to Waldorf after the merger to be characterized as capital expenditures because they would not have been incurred but for the merger, although such expenses are clearly otherwise deductible as ordinary and necessary expenses. [20]

The California divorce proceedings in the *Gilmore* case settled property rights based upon the non-business actions of the parties. By contrast, the New York appraisal proceedings did not involve title to property, and the determination of value was based upon business considerations.[21] The New York appraisal proceedings cannot be characterized as part of the process of acquiring a capital

19. No indirect two step causal determination of origin was required in the *Gilmore* case, as the cause of the litigation was based only on the personal activities of the parties. In addition, the results of the litigation were also determined by their personal activities.

20. Such expenses could include: (a) increases in annual franchise taxes resulting from increased capitalization; (b) printing new stationery, invoices, etc. (c) the legal costs of an amendment to the pension plan of Hilton to allow the participation of the former employees of Waldorf who became employees of Hilton; (d) the installation of a new accounting system in the Waldorf-Astoria Hotel to permit the following of Hilton's procedures; (e) the integration of the Waldorf-Astoria Hotel into the Hilton reservation system; and (f) changes in Hilton's advertising brochures to include the Waldorf-Astoria Hotel. The generality of the application of this Court's decision in this case requires consideration of the classification of such expenses. See the discussion by the District Court on this point. (R. 35)

21. The evidence presented in the appraisal proceeding was directed only to the value of the Waldorf stock, while the evidence presented in the divorce proceeding related to the alleged marital infidelity of the parties.

asset, as all title questions were settled prior thereto, while who was to acquire or retain title to property was one of the principal issues in the *Gilmore* case state litigation.

For the Government to succeed in its argument based upon the *Gilmore* case, it must be held that both the "origin and character" of the proceedings are of a capital nature. The facts do not support a conclusion that either element is of a capital nature. The origin of the proceedings was a debtor-creditor relationship and the character of the proceedings was the determination of the amount of the debt.

Hilton, in the District Court, conceded (R. 33) that the cost of the services of Standard Research *before* the merger to prepare a study to guide Hilton in determining the fair basis of merger between Hilton and Waldorf was a merger cost because functionally a merger could not have been effected without the exchange ratio of stocks being agreed upon by the respective corporations.[22] The Government views this concession as affecting the issue before this Court (U. S. Br. pp. 24-25). However, the services of Standard Research *after* the merger with respect to its expert testimony in the appraisal proceedings were related solely to the determination of the value of the stock of the dissenting Waldorf shareholders on the day prior to approval of the merger.[23] The expenses for such services of Standard Research are clearly not related functionally to effecting the merger. Such expenses are as germane to the appraisal proceedings as the expenses of Hilton in payment of the court appointed appraiser's fee and the fees of the attorneys appearing in the proceeding. The fact that Standard Research performed services with respect to both the merger and the appraisal proceed-

22. R. 5-6, pars. 14, 15 and 16(b).

23. R. 8, par. 23.

ing in no way affects the classification for tax purposes of Hilton's expenses relating solely to the appraisal proceeding.

III.

The Appraisal Proceedings Did Not Result in Hilton Acquiring a Capital Asset.

The Government contends that Hilton's expenses in the appraisal proceeding were incurred as a part of the acquisition by Hilton of the dissenters' shares in Waldorf, and are therefore subject to the provisions of § 263 under the authority of the *Winmill* case. [24]

The services performed by the broker in the *Winmill* case, in bringing the buyer and seller together as the first step in a purchase of a capital asset, clearly "constituted part of the acquisition cost of the securities involved". But there is no analogy between Hilton's appraisal expense and the brokerage commission in the *Winmill* case. The appraisal proceeding was not necessary for the dissenting shareholders to cease to be shareholders of Waldorf and instead become its creditors, as this occurred upon the filing of their written objections and demand for payment for their stock. The determination of the amount owed by Hilton to the dissenting shareholders did nothing to add or subtract from the relationship of the dissenters to Hilton.

In discussing the *Winmill* decision, the Government cites many cases showing the application of the *Winmill* rationale. Most of the cases cited are not relevant to a decision in the instant case, as it is clear that title to a capital asset was the subject matter of the state court litigation and such element is absent in the New York appraisal proceeding. However, two of these cases may appear not to involve title defense or acquisition, and therefore require further analysis.

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24. *Helvering* v. *Winmill*, 305 U. S. 79 (1938).

One of the cases which may appear not to involve title acquisition, but which does, is the *Iowa Southern Utilities*[25] case, which has been characterized as being a case classifying legal expenditures incurred to reduce the cost of property already acquired.[26] However, this characterization is incorrect because in the stockholders' derivative suit in the Iowa courts there were two elements in the litigation: (1) it was necessary for the corporation to establish the liability of the stockholders and directors for wrongfully appropriating monies from the corporation in the guise of sales to the corporation,[27] and (2) it was then necessary for the corporation to establish the amount of such wrongful appropriation. Therefore, *Iowa Southern Utilities* is another case in which the gist of the state court action is the recovery of property, that is the assertion of title to money allegedly wrongfully taken by those defendants who breached their fiduciary duty, and falls within the long line of cases dealing with the capital nature of litigation expenses to acquire property. In this decision, the Eighth Circuit cited with approval the Tax Court statement that: "It is well settled that expenses of acquiring, perfecting or recovering title to property are non-deductible capital expenses" and the Eighth Circuit regarded *Spangler* v. *Commissioner*[28] as a particular significant authority, quoting the following language contained therein:

> "Since perfection of taxpayer's claim to ownership was the essence of the suit, the costs of the litigation

25. *Iowa Southern Utilities Co.* v. *Commissioner*, 333 F. 2d 382 (C. A. 8, 1964).

26. *Petschek* v. *United States*, 335 F. 2d 734 (C. A. 2, 1964).

27. *Des Moines Bank & Trust Co.* v. *Betchel*, 243 Iowa 1007, at 1015, 51 N. W. 2d 174, at 180 (1952). See also description of the nature of the litigation by the Eighth Circuit in the *Iowa Southern Utilities case*, 333 F. 2d 382 at 383 (1964).

28. 323 F. 2d 913 at 920 (C. A. 9, 1963).

were capital expenditures and, under the authority cited, were not expenses deductible from ordinary income."

Another case cited by the Government which does not appear to involve title defense and acquisition is *United States* v. *Morton*,[29] where it was held that attorneys fees incurred for the collection of fire insurance proceeds were not deductible by a corporation in the process of a complete liquidation. However, the analysis of the court in determining when title passed for the purpose of determining the applicability of § 337 resulted in a determination that a fictional sale or exchange occurred because of the provisions of the Internal Revenue Code relating to involuntary conversions[30] at a time not earlier than the date that the offer of the insurer in settlement of the claim resulting from the fire loss was accepted by the insured. Thus, on the basis that title was an integral part of the proceeding for the collection of the fire insurance indemnity, the attorneys fees for such collection were held to be subject to the rules of § 263. But unlike fire insurance collection proceedings, title is not involved in the instant case, so the reasoning in the *Morton* case is inapplicable.[31]

The case *Usry* v. *Price*, 325 F. 2d 657 (5th Cir. 1963) is illustrative of the importance of the absence of the acts of defending or acquiring title in determining deductibility. The *Price* case involved the deductibility of legal fees in the second case in which the State of Louisiana challenged

29. 387 F. 2d 441 (C. A. 8, 1968).

30. § 1033.

31. The *Morton* case relies heavily on *Towanda Textiles, Inc.* v. *United States*, 180 F. Supp. 373 (Ct. Cl. 1960) involving the same issue. However, certain cases are *contra* and hold expenses to determine fire loss amounts deductible. *Ticket Office Equipment Co.* v. *Commissioner*, 20 TC 272, Acq. 1953-2 Cum. Bull. 6, aff'd per curiam, 213 F. 2d 318 (C. A. 2, 1954) and *U. S.* v. *Pate*, 254 F. 2d 480 (C. A. 10, 1958).

taxpayer's title to and right to income from certain oil wells. In this case, the Fifth Circuit said that it was not its province to adjudicate the issue of title but rather to decide whether the issue had been settled and if so at what time. The Court held that since the issue of title had been adjudicated in the first Louisiana case and was *res judicata* in the second case, the attorney's fees in the second case were deductible under § 212.[32]

What the Second Circuit said in *Petschek* v. *United States*[33] is equally applicable to the New York appraisal proceeding:

> ". . . title had been lost long ago and the taxpayer had no chance of regaining it."

Such was the situation of the dissenting shareholders in the instant case.

There are three lines of cases decided by lower courts involving proceedings which have many elements in common with the New York appraisal proceeding in the instant case and therefore are relevant to the application of the *Winmill* case rationale to the New York appraisal proceeding:

> 1. The cases involving legal expenses in a condemnation proceeding, which have generally held that such expenses must be capitalized;[34]

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32. The Government agrees with this analysis of *Usry* v. *Price*, *supra*, but calls the case peculiar. (U. S. Br. pp. 17, 18, n. 12) Perhaps it is the case with peculiar circumstances that best illustrates a legal principle.

33. 335 F. 2d 734 at 736 (C. A. 2, 1964). The Second Circuit is said to have rendered an "able opinion" in the case in 4A *Mertens, Law of Federal Income Taxation* Section 25 A. 16, page 48 (1966 Rev. Ed.) However, taxpayer does not contend this is relevant nor does taxpayer consider references to *Mertens* made by the Government in its brief as relevant.

34. *Isaac G. Johnson & Company* v. *United States*, 149 F. 2d 851 (C. A. 2, 1945) and three cases cited therein similarly holding. But see *L. B. Reakirt*, 29 BTA 1296 (1934), *aff'd per curiam*, 84 F. 2d 996 (C. A. 6, 1934), where expenses of successfully resisting illegal condemnation were held deductible.

2. The cases involving legal expenses in the recovery of the value of property confiscated by foreign governments, which have held such expenses to be deductible;[35] and

3. The cases involving legal expenses in the determination of purchase price in private contracts under which the sale has been consummated, which have held such expenses to be deductible.[36]

The common elements in all these cases are that an acquisition has occurred or will occur, either voluntarily or by unilateral public action, and the purchase price is determined, either by agreed formula or as fair value. The New York appraisal proceeding falls somewhere in between private contracts on one hand, and condemnation and confiscation proceedings on the other hand, being quasi-public and quasi-private, in that the rules for the taking of the stock are set forth by the state, but the stockholder must elect to come within these rules by objecting and demanding payment for his stock.

However, the elements of difference are significant:

(1) In private contract and confiscation cases, the acquisition occurs *prior* to the proceeding to determine fair value or the amount of the purchase price under the agreed formula, while in condemnation cases the time of the acquisition varies, because of the variety of state laws under which condemnation proceedings may occur. For example, title may pass be-

35. *Petschek* v. *United States*, 335 F. 2d 734 (C. A. 2, 1964); *Commissioner* v. *Speyer*, 77 F. 2d 824 (C. A. 2, 1935), *certiorari* denied, 296 U. S. 631; *Commissioner* v. *Ullmann*, 77 F. 2d 827 (C. A. 2, 1935), certiorari denied, 296 U. S. 631; see also *Ruoff* v. *Commissioner*, 277 F. 2d 222 (C. A. 3, 1960).

36. *Naylor* v. *Commissioner*, 203 F. 2d 346 (C. A. 5, 1953); *William C. Atwater & Co.*, 10 TC 218 (1948) (Acq. 1948-1 Cum. Bull. 1).

fore the proceeding to determine the amount of the award commences, during such proceeding, or only after the condemnation award is determined.[37]

(2) Condemnation cases are also distinguishable from the other cases because the award granted by a court is not always based solely on the value of the property taken. Condemnation awards sometimes include, for example, (a) compensation for damages to property not taken by the condemning authority from the injured party in the case of a partial taking (recovery of capital) and (b) damage to the business of the injured party consequentially caused by the nature of a particular taking, when the business itself is not acquired by the condemning authority (loss of income).[38] However, in contrast, confiscation proceedings, private contracts and the instant appraisal proceeding require solely the determination of value.

For these reasons, condemnation proceedings are not completely analogous to private contract and confiscation cases, or the New York appraisal proceeding, and thus their precedent value in the instant case is greatly diluted. Further, the cases deciding the tax classification of expenses in a condemnation proceeding have not recognized or analyzed the various elements of a condemnation award, or the significance of the various times of acquisition, thus weakening any precedent value they may have.[39]

37. 3 *Nichols on Eminent Domain*, § 8.5(1) and (2), (3rd Ed. 1965). This is also true of proceedings to determine the fair value of stock under the variety of state laws and situations which give an objecting shareholder who demands payment for his stock the right to appraisal. See footnotes 48 and 51 *infra*; U. S. Br. p. 23, n. 7; Br. in Opp. p. 12.

38. 64 American Law Reports, 1513.

39. There appears to have been no intensive analysis of the nature of various condemnation proceedings, and any such analysis is absent as well in *Isaac G. Johnson & Co.* v. *United States*, 149 F. 2d 851 (C. A. 2), decided in 1945 before the great body of law

Thus, in the difficult application of § 263, three lines of cases provide conflicting authority, the confiscation and private contract cases weighing in favor of deduction, and the distinguishable condemnation cases weighing in favor of capitalization. It is the position of Hilton that the law is clearer and better considered in the private contract and confiscation cases, and in addition, such cases are more like the instant case than the condemnation cases, which have elements in addition to determination of value which have been neither recognized nor analyzed by the lower courts.

In the only Supreme Court case dealing with the tax effect of a condemnation (in an area not relevant here), *Kieselbach* v. *Commissioner*, 317 U. S. 399 (1942), the condemning authority first took title to the property and then the proceeding to determine the award was commenced, which makes that condemnation proceeding most directly relevant to the New York appraisal proceeding in the instant case. In the *Kieselbach* case, the Supreme Court held that ". . . the purchase price was settled as of January 3, 1933, when the property was taken over." In the same manner, the purchase price of the Waldorf shares was settled as of the date the dissenters filed their written objection and demand for payment with Waldorf. In the instant case the amount of the purchase price (fair value of Waldorf shares) and all other terms of the acquisition were set forth in the state statute, and *nothing* remained to be agreed upon by the parties as a *condition* to the acquisition. The New York court was not determining value

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in the area which is involved in this case was developed. The only two cases which have determined the classification of legal expenses in condemnation cases since 1945 are Tax Court Memorandum Decisions which did not even cite *Johnson* and contain very little analysis. *The Columbus Die, Tool and Machine Company*, 11 CCH Tax Ct. Mem. 1053, 1066 (1952); *T. J. Foster*, 25 CCH Tax Ct. Mem. 1390, 1421 (1966).

as a *requisite* to consummate an acquisition, as parties would in negotiating a sale. An acquisition had occurred, and only the amount of Hilton's liability to its creditors was to be determined in the New York appraisal proceeding.

It is the fact that all of the terms of the acquisition of the Waldorf shares had been settled by state law, and that the New York appraisal proceeding did nothing to restate these terms, which removes the expenses of the New York appraisal proceeding from the *Winmill* rationale as "a part of the acquisition cost". The problem was not to reach mutually satisfactory or binding terms of sale. Because of this, the instant case does not fall within the factual situation decided in *Munson* v. *Mac Ginnes*,[40] but rather within the factual situation decided in *Naylor* v. *Commissioner*.[41] The *Munson* case involved legal fees incurred in securing additional consideration for the sale of stock because the original purchase was induced by fraud and the Third Circuit commented at page 335 concerning this factual situation as follows:

> "More analytically, if terms of sale have been agreed and subsequent controversy concerns no more than the enforcement of these terms against a defaulter the problem is one of 'collection'. [Citing *Naylor* v. *Commissioner*] If the problem is to reach mutually satisfactory or binding terms of sale, the problem is one of disposing of the property, not of collection, and the question of capitalization must be faced."

It is upon this distinction that this case turns in favor of the deductibility of Hilton's appraisal expenses, for the *Naylor* case is hardly distinguishable from the instant

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40. 283 F. 2d 333 (C. A. 3, 1960), cert. den. 364 U. S. 880.

41. 203 F. 2d 346 (C. A. 5, 1953).

case.[42] In the *Naylor* case an option to purchase the stock of taxpayer at the "net asset value" thereof was exercised, but a dispute arose as to the "net asset value" of the stock. The taxpayer, after the exercise of the option, and the creation of an enforceable contract of sale, retained a lawyer to negotiate, and if necessary sue, for what the taxpayer deemed to be the correct price to be paid for his stock based upon "net asset value". The lawyer obtained payment for the stock of the taxpayer of an amount $140,000 greater than stated by the optionee in the exercise of the option, and the amount paid to the lawyer for his services was held to be deductible under § 212,[43] because the taxpayer was incurring his legal expenses only for an enforcement of a claim, resulting from an acquisition which had already occurred.[44]

Thus, in the *Naylor* case, unlike in the *Munson* case,[45] the terms of the acquisition, including purchase price, had been agreed to by the parties, and the services of the attor-

42. The Government contends that *United States* v. *St. Joe Paper Co.*, 284 F. 2d 430 (C. A. 5, 1961) represents the law of the Fifth Circuit, rather than the *Naylor* case (U. S. Br. p. 16 n. 11). However, there does not seem to be any relationship between the two cases. The *St. Joe Paper* case involved the deductibility of the legal fee incurred in the *process* of a receivership proceeding whereby title to stock was *acquired* by the taxpayer in a railroad company in which the taxpayer bought bonds in order to obtain a stock interest. The legal proceeding in the *St. Joe Paper* case involving the acquisition of title to stock is in no way comparable to the *Naylor* case where acquisition of stock was not involved, but rather the determination of purchase price was the issue with respect to an acquisition which had already occurred.

The Government's comment on the *Naylor* case being questioned by the Ninth Circuit in the *Spangler* case is covered in this brief at pages 21-22, dealing with a similar reference by the Government to the *Heller* case.

43. Formerly § 23(a)(2) of the Internal Revenue Code of 1939.

44. *William C. Atwater & Co.*, 10 TC 218, 248 (Acq. 1948-1 Cum. Bull. 1).

45. n. 40 *supra*.

ney were not for the purpose of reopening the terms of acquisition. So it was with the New York appraisal proceeding, which was premised on an acquisition at fair value, and did nothing to reopen the terms of acquisition. It is here that lack of analysis of the possible variety of condemnation cases in the lower courts fails to resolve the basic question concerning Hilton's expenses in the appraisal proceeding.[46]

The Government correctly states that capital expenditures are usually defined as those outlays made to acquire a tangible or intangible asset or benefit with a useful life of more than one year, and the costs incurred in a reorganization, because they have benefit beyond one year, are within this rule (U. S. Br. pp. 10, 11). This rule is important in determining the correct tax classification of the expenditures made by Hilton with respect to the appraisal proceeding. The purpose of the appraisal proceeding was not to confer a benefit upon Hilton with a useful life beyond one year, as the benefits of the merger were unrelated to the appraisal proceeding and had been conferred upon Hilton by the laws of the State of New York upon the filing of the Certificate of Consolidation and the acquisition by Hilton of the properties of Waldorf. Hilton's only purpose in the appraisal proceedings was to keep its liability to the dissenting Waldorf shareholders which it had assumed as a result of the merger to a minimum, a purpose as ordinary and necessary to its everyday activities as resisting what it considers unreasonable demands of any other creditor of Waldorf or Hilton holding a claim against it. There is no distinction between either activity in terms of continuing benefit, as both activities could be characterized as having a benefit beyond one year, as the corporate treasury may be enriched in both cases. To characterize Hilton's expenditures in the appraisal proceed-

46. n. 39 *supra*.

ing as having a continuing benefit beyond one year is to stretch the concept beyond reason and its intendment.[47]

IV.

The Lower Court Cases Holding Expenses of an Appraisal Proceeding Deductible Are Correct.

In addition to the cases before this Court, the problem of tax classification of appraisal expenses have been the subject of many cases in lower courts, and all but one of these cases have held such expenses deductible.[48]

Uncomfortable with the preponderance of cases in favor of taxpayers, the Government states that *Heller* does not represent the law of the Ninth Circuit and that the Ninth Circuit specifically disapproved of its *Heller* opinion in *Spangler* v. *Commissioner*.[49] This is not a fair analysis of the *Spangler* case. To support its position the Government relies upon footnote 15 on pages 919-920 of the *Spangler* decision (U. S. Br. pp. 15-16). The statement notated by the Ninth Circuit was:

"The gist of the controversy between taxpayer and

47. *Chicago Dock & Canal Co.*, 32 BTA 231 (1935) aff'd *per curiam*, 84 F. 2d 288 (C. A. 7, 1936), holding as deductible the legal expenses incurred in successfully resisting the imposition and amount of a special assessment having a continuing benefit to real estate.

48. Cases favoring taxpayer: *Heller* v. *Commissioner*, 147 F. 2d 376 (C. A. 9, 1945), affirming 2 TC 371, certiorari denied, 325 U. S. 868 (shareholder expense upon merger); *Smith Hotels Enterprises, Inc.* v. *Nelson*, 236 F. Supp. 303 (E. D. Wisc. 1964) (corporate expense upon sale of assets); *The Vermont Bank and Trust Company* v. *United States*, 296 F. Supp. 682 (D. C. Vt. 1969) (corporate expenses on merger); *Stempfel* v. *United States*, 23 AFTR 2d 69-685 (M. D. Tenn. 1969) (stockholder expenses on merger). The case favoring Government: *Boulder Building Corp.* v. *United States*, 125 F. Supp. 512 (W. D. Okla. 1954) (corporate expenses on extension of corporate charter).

49. 323 F. 2d 913 (C. A. 9, 1963).

> the managing officers in the state court litigation was the ownership of the stock."

This is to be contrasted with the finding of fact upon which it based its *Heller* decision:

> "The Tax Court in its finding of fact found that in this litigation the taxpayer was not defending or asserting its title."[50]

Thus, there was no reason for the Ninth Circuit to disapprove of its *Heller* decision in *Spangler*, as the cases were distinguished on their respective facts. Indeed, the Ninth Circuit did not disapprove of the *Heller* case, as footnote 15 reads:

> "The present case is thus distinguishable from those in which it has been concluded that the primary issue was not ownership but rather the right to possession [citations] . . . , or the price to be paid for property . . . [citing *Naylor* and *Heller*]. Moreover, as we have suggested, to the extent that these cases . . . assume that section 23(a)(2) [now section 212] created a new category of deductions . . . we think they are based upon an unsound premise."

Footnote 15 is more properly interpreted as an approval by the Ninth Circuit of its *Heller* decision as the *Heller* decision does not assume any "new category of deductions".

The Government tries to distinguish the cases favorable to the taxpayer which rely on the "primary purpose" test, stating that in *Hilton* there was no element other than title acquisition involved in the New York appraisal proceeding (U. S. Br. p. 17). Hilton agrees that the instant case is indeed distinguishable from the cases applying the "primary purpose" test, because *only the amount owed* by Hilton to the dissenters based upon the value of their Waldorf shares was at issue in the New York appraisal

50. 147 F. 2d 376 at 377 (C. A. 9, 1945).

proceeding. Hilton further does not seek to come within the umbrella of the "primary purpose" test for this reason. However, Hilton agrees with the petitioner in the *Woodward* case (No. 412) that the "primary purpose" test is relevant in classifying appraisal expenses in proceedings which also involve an element of title.

The circumstances under which appraisal proceedings occur are varied,[51] and with respect to events which cause appraisal, the rules of state law may differ,[52] and therefore passage of title may occur at different times in relationship to the appraisal proceedings. The Government argues since all appraisal proceedings have one element in common (determination of value) that all appraisal proceedings should be treated in the same manner, and such expenses should be capitalized without determining the purpose of the proceeding (U. S. Br. p. 22). But such an argument cuts both ways, as it may be argued that since all appraisal proceedings involve determination of value, the expenses of all such appraisal proceedings should be deductible. This would bring as much simplicity and certainty in the administration of the Federal income tax law as the Government's position.

However, Hilton believes that neither position is valid. Courts have been successfully applying the "primary purpose" test in determining the application of § 263 since 1913, and there is nothing unique in an appraisal proceeding which would preclude the application of the test by looking to the underlying substantive rights of the parties under state law, and determining the primary issue being litigated in the state court proceeding. Fairness in the administration of the Federal income tax laws should

51. Examples are: (1) merger, (2) consolidation, (3) exchange of corporate shares, (4) sale of all or substantially all of the assets of a corporation, and (5) continuation of corporate charter.

52. U. S. Br. p. 23, n. 17; Br. in Opp. 12.

be a more important goal than simplicity in its administration. To the extent that the issue or the transaction involved in appraisal proceedings differ, each should be treated in accordance with established tax principles.[53]

The Government argues that such a position by this Court would allow refinements of title under state law to govern Federal tax consequences (U. S. Br. p. 22). But in the cases cited by the Government, it was found there were no substantive state law distinctions for Federal income tax purposes in determining when income is realized or the nature of such income, and these cases do not deal with § 263, which by its terms deals with property rights, which can only be determined by state law.

In his administration of the tax laws the Commissioner of Internal Revenue must make determinations of state law, and this is most appropriately demonstrated by Revenue Ruling 68-285[54] involving an appraisal of the value of dissenters' stock.[55] Surely the Government can-

53. The Government states (U. S. Br. p. 18) that Hilton "... seems to agree the *Woodward* was correctly decided . . ." However, Hilton neither agrees nor disagrees with the *Woodward* decision, and has not addressed itself to that problem in this brief. The distinctions made between the facts in this case and in the *Woodward* case were made in Hilton's Brief in Opposition solely for the purpose of attempting to demonstrate there was no conflict between the Circuits.

54. 68-1 Cum. Bull. 147.

55. Under a state banking law allowing dissenters rights for the payment of the value of their stock, Bank X acquired in exchange for its stock, all of the stock of Bank Y, other than the 25% of the stock of Bank Y owned by dissenting shareholders. The transaction was held to be a reorganization under § 368(a)(1)(B) which has two requirements germane to the ruling: (1) the stock of Bank Y had to be acquired solely for voting stock of Bank X and (2) after the exchange Bank X had to own at least 80% of the stock of Bank Y in order to meet the control requirements of § 368(c).

Bank Y established an escrow fund prior to the exchange from which payments of cash to the dissenters were made both before

not contend that the Commissioner may make determinations of state law in appraisal proceedings to determine substantive tax questions, but courts should not.

The Government excludes from its statement concerning refinements of title under state law those cases where "the revenue statutes explicitly or implicitly so provide." (U. S. Br. p. 22). Issues to be decided under § 263 must refer to state law to determine whether there is a defense or perfection of title and there is an explicit reference in the statute to the increase in value of an estate, which can only be determined under state law. All of the "primary purpose" test cases must by their nature rest on an analysis of state law. The nature of corporate powers and status of individuals as stockholders have been determined by courts in deciding substantive tax consequences.[56] Thus, while the Government's contentions concerning state law

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and after the exchange, and any cash not so expended was to be returned to Bank Y (then a wholly owned subsidiary of Bank X). Under these circumstances Bank X was determined *not* to have acquired any Bank Y stock for cash, and thus met the solely for voting stock requirement. The Revenue Ruling notes that this requirement would not have been met if "the acquiring corporation pays the dissenting shareholders or reimburses the acquired corporation for its payment to the dissenting shareholder."

A further analysis of state law was required of the Commissioner to determine whether the 80% control requirement was met. Here the determination was that since "under the state banking law, each dissenting shareholder . . . ceased to have any shareholder rights except to the right to demand payment for the fair market value of his shares, [T]herefore immediately after the exchange, X owned all of the outstanding Y stock."

Thus detailed analysis of state law was required to determine substantial income tax consequences, and this analysis resulted in a determination that Bank X did not acquire any stock of Bank Y, under the appraisal procedure discussed in the ruling.

56. For example, see *Stevens Brothers Foundation, Inc.* v. *Commissioner*, 324 F. 2d 633 (C. A. 1963); *Collateral Equities Trust*, 39 BTA 834 (1939) (Acq. 1939-1 Cum. Bull. 7), which cases decided the application of the personal holding company tax based upon state law determinations of a corporation's powers and when a person becomes a stockholder.

are true, they are inapplicable to the cases before this Court.

In summary, since Hilton did not acquire a capital asset as a result of the New York appraisal proceeding, and since there is no functional relationship between the appraisal proceeding and the merger so as to make rules concerning mergers applicable, the expenses of Hilton in the appraisal proceeding are deductible as an ordinary and necessary expense under § 162.

CONCLUSION.

The decision of the Seventh Circuit should be affirmed.

Respectfully submitted,

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APPENDIX.

New Stock Corporation Law, 58 McKinney's, Consolidated Laws of New York, Annotated:

§ 21. *Determination of value of stock of objecting stockholder.*

1. In the event that the stockholders of a corporation have taken action pursuant to sections . . . ninety-one . . . and if any stockholder has objected to such action and demanded payment for his stock as provided in section . . . ninety-one . . . the corporation . . . within ten days after the last day on which a demand for payment might have been made, shall mail by registered mail to such objecting stockholder or deliver personally to him a written offer to pay for such stock in cash at a price deemed by the corporation to be the value thereof; and an offer so made to any such objecting stockholder shall also be made on the same terms and conditions and at the same price per share to all such objecting holders of shares of the same class of stock . . .

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3. . . . If the objecting stockholder shall fail to accept an offer from the corporation within twenty days after the mailing or delivery thereof, . . . such stockholder or the corporation may petition the supreme court . . . to determine the value of such stock . . .

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4. . . . The court shall . . . proceed to determine the value of their stock, or shall appoint an appraiser to determine such value . . . For all the purposes of this section, such value shall be determined as of the close of business on the day before the taking of the stockholders' vote on the action to which objection was made, excluding any appreciation or depreciation di-

rectly or indirectly consequent upon such action or the proposal thereof . . .

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6. Any stockholder demanding payment for his stock shall have no right to receive any dividends or distributions payable to holders of such stock of record after the close of business on the day next preceding the date of the stockholders' vote in favor of the action to which such objection was made, and upon such vote shall cease to have any other rights of a stockholder of the corporation with respect to such stock, except the right to receive payment for the value thereof as in this section provided; and no such demand may be withdrawn unless the corporation shall consent thereto . . . if the action to the taking of which objection was made shall be abandoned or rescinded, the status of such stockholder as a stockholder in the corporation thereupon shall be restored . . .

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7. . . . if payment for the stock of an objecting stockholder shall have been demanded in consequence of action taken on a merger or consolidation pursuant to sections eighty-five, eighty-six or ninety-one, the shares or other securities of the resulting or surviving corporation into which the shares of the objecting stockholder would have been converted had no objection been made shall, unless the certificate of merger or consolidation shall otherwise provide, be deemed to have been duly issued in accordance with the terms of such certificate and reacquired by the resulting or surviving corporation, and may be held or disposed of by it free of any preemptive rights of stockholders . . .

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8. Within twenty days after the last day on which a demand for payment might have been made, each stockholder demanding payment, unless the offer of the corporation to pay therefor shall have been accepted, shall submit his stock certificate or certificates to the corporation for notation thereon of the fact of such demand; and any stockholder who shall fail so to

do shall not be entitled to the relief by this section provided unless a court of competent jurisdiction, for good and sufficient cause shown, shall otherwise direct. Upon any subsequent transfers of such stock on the books of the corporation prior to payment by the corporation of the value thereof, as herein provided, the new certificate or certificates issued therefor shall bear a similar notation, together with the name of the original objecting holder of such stock, and until such payment shall have been made, no transferee of any such stock shall acquire any rights of any character whatsoever by reason thereof except the rights of the original objecting stockholder.

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§ 91. *Consolidation of domestic with foreign stock corporations.*

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7. Any stockholder of a domestic corporation included in such consolidation, not voting in favor thereof, may object to such consolidation and demand payment for his stock, at any time prior to the vote . . . The objecting stockholder or the corporation shall have the right to have such stock appraised and paid for in the manner provided, and subject to the conditions imposed by section twenty-one . . .

• • • • •